

Business Results for Fiscal 2022 Q&A (for Investors)

【date】13:00-14:00, May 10, 2023

【presenter】 2 persons

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【questioner】 4 persons

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Sakai [Q]:

It appears that the forecast for FY 2023 includes a fairly sizeable forex impact. It would be great if you could explain the mechanism of the impact from forex in a little more detail. Generally speaking, a depreciation in the value of the yen is naturally a positive factor for sales. However, in the case of Tsumura, given the large volume of imported raw materials, I believe the portion of negative impact from a depreciation in the value of the yen is invariably notable. That being said, Tsumura holds on to its inventory for around two years. In light of this, the spot rate today will not necessarily readily apply to the cost of sales a year from now. What factors stacked up to equal the ¥2.4 billion you have come up? Going forward, it is unclear whether the yen will or will not continue to depreciate in value. At this point, I believe this an uncertain factor. Can you explain the manifestation mechanism? This is my first question.

Handa [A]:

The forex rate mechanism is a positive factor for sales, even if the yen depreciates in value. A rise in import expense as a part of the expense of crude drugs, which

makes up a large portion of raw materials, is a negative factor. Then there is processing expense. This is slightly negative as there are impacting factors on the China side. As for SG&A expense, the impact is not that sizeable. The difference with FY 2022, when looking back, the average rate for the annual JPY/RMB rate, which is disclosed, for example for FY 2021, was ¥17.02/RMB. In FY 2022, the rate was ¥19.49/RMB. There isn't a big change from that point, but the crude drugs make up a large portion of raw material expenses. You mentioned the current inventory and the possible outcome a year later, and we are using forex forward contracts as a hedge against the rise in the cost of crude drugs to the best of our ability in the situation that the yen keeps weakening. Our scheme aims for a maximum coverage of around 70% of forex translations for a period of up to 1 year and up to 80%-90% in the near term, and a maximum coverage of up to but not over 50% after 2 years but less than 3 years. There was a sharp devaluation of the yen in the market from 2021 to 2022. 2022 is relatively recent, therefore, we booked many forex forward contracts. However, these contracts cover forex translations 2 and 3 years ahead from 2023. As I said, the forex forward contract coverage ratio is around 30% or even as low as 20%. We were not able to book forward contracts at a very good rate. In light of this, the impact from the spot rate will be sizeable.

I might have discussed this before. Theoretically, for every 1 yen decline in the value of the yen against the RMB, assuming the absence of forward contracts, the full impact to cost of sales will be a negative impact of around ¥1.4 billion. As I just said, this reflects the speed at which the yen depreciates in value in the market and the range of forex translations. In comparison with FY 2022, the impact from forex is likely to be considerable in FY 2023 due to this mechanism.

Sakai [Q]:

So what is your estimated forex rate, I mean your forward contract rate for 2023?

Handa [A]:

Our estimated forex rate is ¥19 per RMB. However, this is merely our estimate. It is a spot rate and the forward rate is still slightly better than the spot rate. Conversion will not all be carried out at this rate.

Sakai [Q]:

I understand. Thank you. Also, I may have missed this but in the sales portion, but regarding the total for drug-fostering program formulations this time around, the growth in sales in this category is slightly slowing down. The growth in total sales for 119 formulations other than the drug-fostering program and growing formulations is 4.5%. Sales of growing formulations increased 10.3%. This may have been within the scope of expectations, but Tsumura is constantly claiming that the benefit from e-promotions and the expansion of the range of face-to-face sales activities by MRs is an issue. From a sales perspective, was the outcome for FY 2022 and the sales results for drug-fostering program formulations, and growing formulations, and in other areas within the scope of expectations? Or do you believe that you needed to grow drug-fostering program formulation sales a little more? Can you explain this?

Sorada [A]:

First, regarding drug-fostering program formulations, as you pointed out, we did anticipate slightly more growth. A major factor was the response to the “restricted shipments” implemented in and after the end of August, particularly as MRs scrambled to respond to inquiries from dispensing pharmacies. This was a huge point. Another factor was the substantial impact reflecting our slight ease up on e-promotions due to the implementation of restricted shipments. Sales for formulations other than for the drug-fostering program and growing formulations rose 4.5%. This likely reflects the development of the number of physicians writing 10 or more prescriptions, owing to the establishment of Kampo medicine. We believe this is serving as a foundation.

Kawamura [Q]:

Can you give us more details of the “comings and goings” in the FY 2023 operating profit forecast for the domestic business? In your plan this time around you forecast sales growth but you released a forecast for a profit decline in the domestic business. Tsumura is one of the few companies where the NHI drug price revisions are positive factors. Even with deterrents including energy procurement costs, I have not yet convinced that profit will decline of this extent. Can you provide a further explanation of these “comings and goings?” I believe the growth investments are sizeable. It is correct to assume these are one-off items? Can you explain this?

Handa [A]:

First, we gave a simple explanation today of the content on slide 15. The negative impact from external factors in this slide totals ¥2.4 billion. This is exactly how it looks. We touched upon the uptick in cost for some wild crude drugs and the issue with Japanese peppers. The rise in the procurement cost for crude drugs is primarily attributable to an increase in cost for several crude drugs. Soaring energy and raw material costs is not just an issue with Tsumura alone. The rise in electricity and power costs is substantial. And then there was forex. As I mentioned just now, this had a negative impact of ¥2.4 billion. Our estimated forex rate is ¥19/RMB and we have few forward contracts at good rates in comparison with FY 2022. This is likely to have a considerable monetary impact.

Then there is our growth investment of ¥3.5 billion to realize our vision. This includes one-off items and also growth investments to ensure the next phase of growth. Specifically speaking, for instance, this includes research and development expense of ¥800 million. Or in relation to DX promotion I mentioned earlier, an investment of ¥900 million in a DX system. Or as for one-off items, at present we are strengthening our production and plan to proactively or limitedly acquire production personnel. This will entail an investment of ¥300 million. This includes various investments of this nature. Either way, we are planning investments that

will support recent growth. We are therefore carefully selecting these investments.

Kawamura [Q]:

I understand. Thank you. I would additionally like to ask about wild crude drugs. I believe Tsumura has been raising the ratio of cultivated land under proprietary management by a fair degree for some time in an effort to lower the cost of the wild crude drugs it procures and stabilize costs. Wouldn't it be better to think that the procurement cost of wild crude drugs are not controllable and that in the future the cost is likely to waver around ¥1.0 billion?

Handa [A]:

Thank you for your question. Grasping these figures is slightly difficult in the market. As you pointed out, we are growing 80% or more of domesticated products are grown on cultivated land under proprietary management. The price and quality of these crude drugs are relatively stable. Naturally, the rise in prices, which will correspond to inflation in China, will surface, although somewhat lagging. As I mentioned in my presentation, we are pushing forward with the domestication of wild crude drugs. We will not domesticate all wild crude drugs but we plan to domesticate those wild crude drugs whose prices are skyrocketing and which are easily affected by the weather. It is our plan to prioritize the domestication of these wild crude drugs. Also, as I touched upon this in the topic of Japanese peppers, we plan to increase the amount of Japanese peppers we are planting to achieve a balance between supply and demand. We are implementing measures such as this in the medium term.

Kawamura [Q]:

I may be getting ahead of myself but my second question is about the next fiscal year. I want to talk about price. Precisely, NHI drug price revisions. The NHI drug price revision this time around had a positive impact. Tsumura is one of the few companies for which this was positive. However, performance in Japan appears to

have been fairly harsh. I am sure there are various external factors. In the next NHI drug price revisions, assuming the prices are revised downward next time in 2024, it looks like it will be difficult for Tsumura to generate a fair amount of profit growth. What kind of talks do you have with the government ? Do you see sales trending flat at the very least or will the government show their understanding of soaring energy prices and implement a positive revision? Can they see what is coming next? Can you give us a hint? What are you currently discussing with the government? Can you give us even a slight outlook?

Kato [A]:

This topic cannot be addressed by a single company. Regarding NHI drug prices, the Japan Kampo Medicine Manufacturers Association (JKMA), an industry association, is our key governing body. The organization above this is superior body, the Federation of Pharmaceutical Manufacturers' Associations of Japan (FPMAJ). The JKMA compiles opinions and submits statements or declarations based on this to the FPMAJ. Through this process, FPMAJ can understand situations. The Central Social Insurance Medical Council (Chuikyo) carries out final discussions on the matters that are brought up. Naturally, there are many different members participating in the Chuikyo. There are paying members, members from the medical side and manufacturers. There is also the administrative side. In light of this, thus far we have carried out measures having properly explained our situation to the Chuikyo. And we plan to continue doing so going forward.

One factor that generated positive impact from the NHI drug price revision this time around was our tenacious efforts for considerably long periods of time to talk to our wholesalers and sales agents/distributors, asking them to conduct sales that are commensurate with the value of Tsumura Kampo products. We have seen considerable progress with the cooperation from them. In light of this, this time around the NHI drug price revisions were a positive factor for us. However, this was positive in part reflecting the absence of negative factors in this drug price revision. Being subject to re-pricing unprofitable products means further stable supply of

those products are required. We ask for understanding of our objective and also to carry out sales of Tsumura products at fair prices. In addition, we are also naturally petitioning industry associations. As shown in the cost breakdown we just presented, we are very grateful to have positive impact but this alone will not cover costs. Given this, it is our goal to make a continuous appeal to ensure stable supply and continue to make an appeal to patients and the market, so as not to cause any inconveniences or problems.

Akahane [Q] :

First of all, I would like to discuss your results. Looking at individual products, it appears that sales are growing for Kamikihito and Goreisan. You explained this earlier. This reflects the after-effects of COVID-19. I believe Kamikihito is used to treat insomnia, and Goreisan is used for dizziness. Also, sales of Hochuekkito are also definitely growing. I believe it is being used to treat a wide range of after-effects. In the most recent book-closing, I think sales grew for Kampo products used to treat symptoms related to the after-effects of COVID-19. Is my understanding correct? Also, at the end of 4Q, the NHI drug price rose around 3% on average therefore I think there was provisional demand, rather than a refrain from purchasing. Looking at the details, I believe sales rose for the likes of Kakkonto and Goshajinkigan. Shipments of these products were suspended so there was no way provisional demand could be triggered. Consequently, although the NHI drug price rose, provisional demand did not occur. In the quarter just completed, the after-effects of COVID-19 were the main driver for sales growth. Is my understanding correct?

Sorada [A]:

As you pointed out, we believe these Kampo products are being used to treat the after-effects of COVID-19. Goreisan is now being frequently used to treat edema and swelling in patients with chronic heart failure. Consequently, sales rose substantially in comparison with the same period, in the previous fiscal year. It was

found that Kamikihito triggers the secretion of the hormone oxytocin. This hormone is sometimes known as the “love hormone.” This hormone has an extremely positive impact on feelings of anxiety. Kamikihito is therefore frequently used in various treatments, not only for COVID-19.

As for provisional demand, from the perspective of stable supply, supply must not become unstable should provisional demand suddenly arise. Consequently, we are securing the cooperation of each pharmaceutical agency and addressing situations so that abnormal demand does not occur.

In light of this, given the results of their use to treat the after-effects of COVID-19, we are gaining understanding of the efficacy of Kampo products. We aim to take steps to continue to expand demand.

Akahane [Q] :

In addition, the sales growth for Bakumondoto was negative but this can be used for COVID-19 for prolonged coughs. Its use for treating coughs is likely not limited to COVID-19. However, in the end, shipments of Bakumondoto were suspended so the sales growth was negative. In light of this, sales rose for COVID-19-related products. Ultimately sales growth was negative for those products that could not be shipped. I came away with the impression that sales of COVID-19-related products basically grew. Is this accurate?

Sorada [A]:

As you pointed out, we restricted shipments of Bakumondoto. I am not saying these were alternatives to Bakumondoto but we have strong line-up of Kampo products that can be used to treat coughs. There are 5-6 types of Kampo products, sales of which all grew substantially. We believe this strongly reflects the impact from the still unstable supply of Western generic cough suppressants. So, there is a substantial increase in cases where Kampo medicine is being used, for instance, not just for COVID-19 but also coughs as a symptom accompanying influenza.

Akahane [Q] :

Thank you for your explanation. My second question is about your forecasts. Reflecting this, I would like to bring up a question about drug prices that were discussed earlier in the questions. You stated the NHI drug price revisions this time around were a positive factor. Looking at the details, sales rose for products such as Goshajinkigan and Kakkonto, in other words products you were not able to ship. I am sure the government is giving consideration to the issue of stable supply. Although I do not have an accurate understanding, based on what you said, you resumed shipments of Goshajinkigan on April 3, and plan to resume shipments of Kakkonto in June. If you are truly able to carry out the resumption of these shipments, I would assume that you would achieve a certain degree of sales growth. However, your forecast for a double-digit profit decline seems a bit harsh. What is your explanation for this? How do you view the sales growth of mainstay products, including those for which shipment was suspended?

Sorada [A]:

As Director & CFO Handa previously explained, this is on a sales volume basis. This is not a drug price basis but a monetary basis therefore we believe sales will grow 4%-5% on a volume basis. For a Kampo product of which scale of sales is fairly large, like Daikenchuto, I believe sales growth of 4% or 5% is somewhat harsh. For other products, such as Kamikihito, we believe sales growth is in the double digits. In light of this, for those products for which the drug price rose, we mentioned that the portion the price rose contributes to the sales growth to the same degree. We aim to firmly do our best.

Akahane [Q] :

NHI drug prices rose nearly double digits. According to your new release on Goshajinkigan and Kakkonto, restrictions on shipments were lifted for Goshajinkigan in April and restrictions on Kakkonto are scheduled to be lifted in June. This leaves 24 products for which shipments are currently restricted. Do you anticipate there

restrictions will be lifted around June? Are your numbers based on these assumptions?

Sorada [A]:

We believe almost all restrictions will be lifted around the first week of June. In light of this, we plan to cooperate with the Production Division and tackle this situation to ensure stable supply. Once lifted, It is not likely that we will be faced with restricted shipments. At present, we are inconveniencing many patients. We regret this. We are terribly sorry.

Akahane [Q] :

The positive factors from the NHI drug price revisions are uneven. Assuming drug prices for some products, such as Goshajinkigan and Kakkonto, rise, it is my view that you would not end up with the numbers you presented to us. Don't you believe this could be misleading?

Sorada [A]:

The drug price for Goshajinkigan rose around 10%. Kakkonto is a seasonal product so when it is cold season, consumers will naturally use a lot of this product. One more thing you need to keep in mind is that although drug prices were raised, they were mainly for products with little-to-no profit margin. Some original NHI drug price bases are set very low. Amid this, it is our goal to properly provide information in a way that doctors will prescribe Kampo formulations that are suited for the patient.

Akahane [Q] :

I don't mean to nitpick but if prices rose for products with little-to-no profit margin, wouldn't that be the best positive factors in terms of profit? Isn't that correct? The most positive factor in terms of profit would be if the NHI drug price rose and acted as tailwinds for products with little-to-no profit margin. Is my understanding in

correct?

Sorada [A]:

Of course, what you are saying is correct. If prices for products with little-to-no profit margin were to rise, that would reduce the negative portion. However, we don't think that the cost-to-sales ratio has been solidly resolved or, how should I put this, it has risen to a sufficient degree. The raw material expenses are still severe. As was explained earlier, there was a 10% rise in drug prices reflecting the climb in prices for crude drugs, as you stated. Will this rise in the NHI drug price for Goshajinkigan for instance fully resolve the fact that this product is unprofitable? From the standpoint of the Sales Division, this is quite tough issue.

Hyogo [Q]:

Director & CFO Handa, in his presentation, commented that management recognized that Tsumura's PBR of below 1x is an issue. I believe the Tokyo Stock Exchange, in tandem with its recent reorganization, is requiring companies with a PBR of below 1x to come up with some type of improvement plan. Given your business model, which requires a fair amount of capital expenditures as well as the need for China-related investments, Tsumura is unlike other companies that have the option of saving up cash and putting it towards the buyback of shares or for dividend payouts. With respect to how to raise a PBR to the level of 1x, what do you believe the issue is and what is dragging your PBR below 1x during a certain period? How do you plan to maintain a PBR of 1x going forward? Do you have plans for boosting this to above 1x? If so, can you disclose this plan? Also, tell us what discussions you have had about this as management.

Handa [A]:

As you pointed out, our business model entails the need for large-scale capital expenditures. This is also indicated in our current medium-term management plan. We plan to effectively utilize our cash reserves for this. However, as was mentioned

earlier, our investments are for the purpose of realizing definite growth going forward. Consequently, when it comes to overcoming our undervaluation (a PBR of below 1x), I believe it all comes down to putting Tsumura on a solid growth trajectory.

We believe the earnings structure of the domestic business will change dramatically if we put our production system in order in Japan, strengthen sales as was discussed earlier, and gain an understanding about how the NHI drug prices function. Demand in China is growing. The Crude Drug Platform business is continuing to grow and the Formulation Platform business has finally succeeded at realizing an M&A deal, through which we will see business development in this area. Our ability to achieve business development at this point will likely alleviate the uncertainties that have inundated the China Business thus far and the doubts about NHI drug price issues. By making these major issues become clearer, I believe stakeholder expectations in Tsumura will change. I hope you will gain an understanding about our current plans and our decisions on investment projects are made through these discussions .

Hyogo [Q]:

This is a follow-up question, or should I say it is what I am feeling. Although you have disclosed a medium-term management plan, one issue I recognize is that Tsumura's medium/long-term growth potential is not shared in the capital markets. Due to this, I believe that if you disclose a revised version of your medium-term management plan in the future, dialogue with the capital markets should be held, although I am sure that you have carried out thus far. I feel that unless you make efforts to promote better understanding, you will not fill the gap with market participants. I also believe that your management team needs to go back and discuss whether this is truly the optimal allocation of capital. I believe that Yanagisan has joined Tsumura as an outside director. I believe you should thoroughly discuss this issue to ensure that a PBR of below 1x does not become a chronic issue that will take time to improve. I truly hope you will do this. The last part was just

my opinion. Thank you.

Handa [A]:

Thank you for your valuable opinion. We have been receiving various opinions from everyone. We plan to move forward while leveraging the opinions you expressed today.

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